An Economic Assessment of Federal Monetary Policy

Prepared for:

Government of British Columbia

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Informetrica Limited

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Limited

An Economic Assessment of Federal Monetary Policy

Executive Summary

1. Commencing in 1989 the Federal Government through the Bank of Canada embarked on a more restrictive monetary policy by raising interest rates in an effort to achieve a significant reduction in the Canadian rate of inflation. As a result, Canadian short-term interest rates rose almost 5 percentage points higher than U.S. rates. The value of the Canadian dollar also appreciated from about $.81 U.S. to over $.86 U.S. Informetrica was commissioned by the B.C. government to assess the impact of this policy.

2. In the view of Informetrica there was no justification for this policy change. The Canadian rate of inflation was comparable to that in the U.S. and did not pose a problem justifying a significantly more restrictive monetary policy. Indeed, the pursuit of a more restrictive monetary policy has caused significant harm to the Canadian and B.C. economies.

3. Informetrica used its economic models, TIM and RIM, to quantify the impact of the tightening of federal monetary policy on the Canadian and B.C. economy. The results show that the tightening of monetary policy commencing in 1989 had a significant and negative impact on the economy. The impacts summarized in the following table show that federal monetary policy was responsible for the recession in 1991. Economic output was reduced by 3% below what it otherwise would have been, investment was curtailed and unemployment increased in direct response to federal government policy. In total there were 139,000 fewer jobs in Canada and 15,000 fewer jobs in B.C. in 1991 as a result of monetary policy.

IMPACT OF FEDERAL MONETARY POLICY, 1991

	Canada	B.C.
Real Gross Domestic Product	-3.0%	-2.9%
Employment (thousands)	-138.5	-15.0
Unemployment Rate	.95%	1.1%
Total Real Investment	-4.2%	-3.8%
Budget Balance ($ millions current)	-5,600	-493

4. Particularly interesting is the impact of monetary policy on the Federal and B.C. government deficits. If the federal government had not tightened monetary policy, the federal deficit in 1991 would be $5.6 billion lower and the B.C. deficit would be about $500 million lower. In other words, the federal government could have significantly reduced its deficit without resorting to tax increases and achieved higher economic growth if it had not unnecessarily tightened monetary policy.

5. The estimates above assume that monetary policy was not tightened from that existing in 1988. If monetary policy was more expansionary then the positive impacts on economic performance would be even more pronounced.

6. The above results show that federal monetary policy has been misguided and damaging to the Canadian and B.C. economies. Consequently, Informetrica Limited recommends an alternative policy consisting of lower interest rates and a lower exchange rate, To assess the impact of such a change in policy, Informetrica used its economic model to show the effect on key variables if short-term interest rates were reduced by 2 percentage points and the dollar was allowed to depreciate to $.845 U.S. The impacts summarized in the following table show significant and positive benefits for the economy. By 1995 real output for Canada is about 3.6% higher and there are 214,000 additional jobs. The federal deficit is reduced by $8.8 billion in 1995.

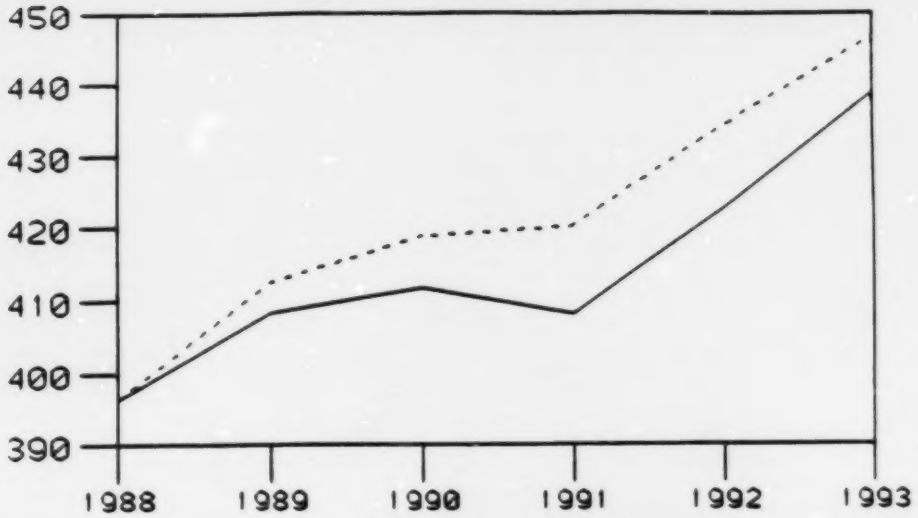
7. The impacts on B.C. are equally impressive. For 1995, economic output is 3.1% higher and there are almost 18,000 more jobs. Investment is 7% higher and the provincial deficit is reduced by $980 million. The provincial debt in 1995 is $2.4 billion less.

ECONOMIC GAINS FROM AN ALTERNATIVE MONETARY POLICY, 1995

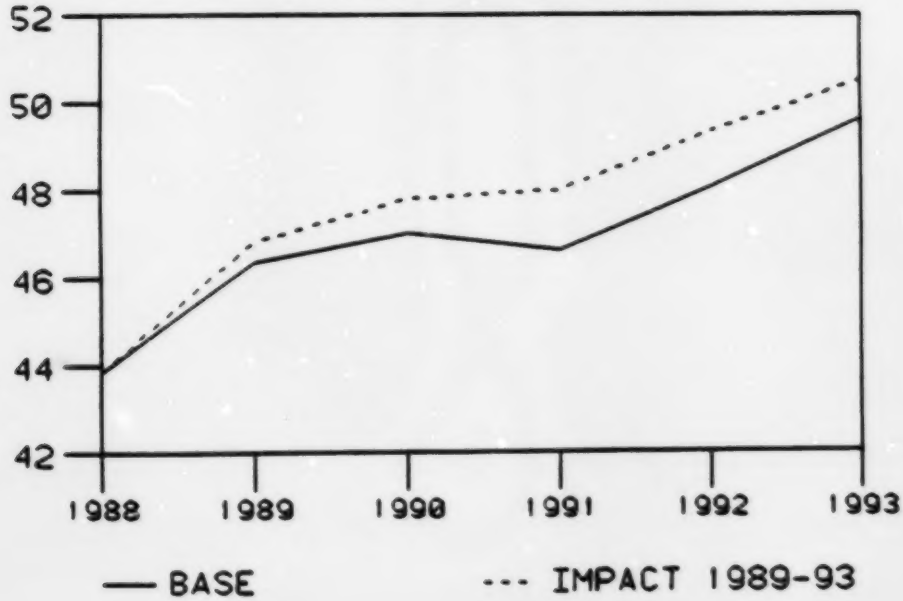
	Canada	B.C.
Real Gross Domestic Product	3.6%	3.1%
Employment (thousands)	214.3	17.6
Unemployment Rate	-1.4%	-1.5%
Total Real Investment	8.0%	7.1%
Budget Balance ($ millions current)	8,800	980

8. This study clearly shows that federal economic policy has had a significant and negative impact on the Canadian and B.C. economies. In 1991, 139,000 people in Canada and 15,000 people in B.C. are unemployed as a result of the tightening of federal monetary policy. Without a change in policy, the economy will continue to suffer from high unemployment, low productivity growth and higher government deficits and taxes. It is clearly time for a new policy approach consisting of lower interest rates and a lower dollar. Until full employment is achieved, some of the improvements to government balances should be recycled through increased public investment.

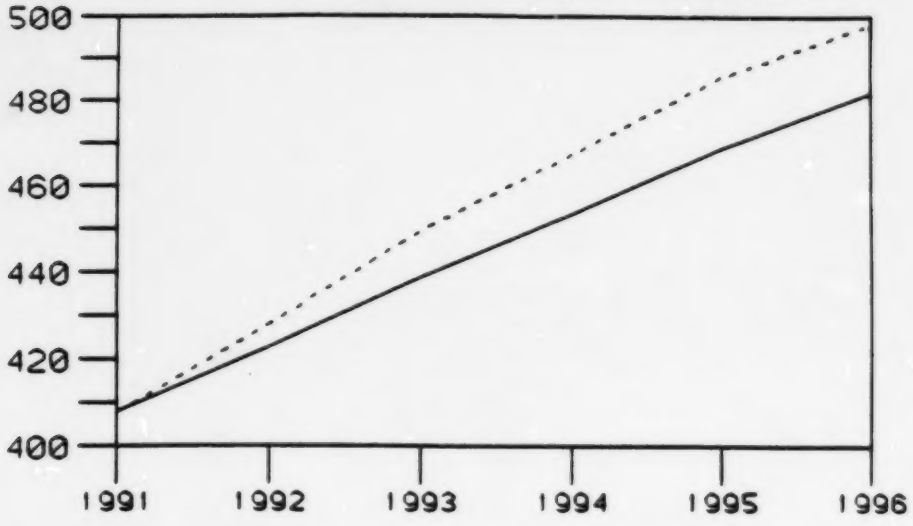
CANADA
GROSS DOMESTIC PRODUCT, 1988-93
(billions of 1981 dollars)



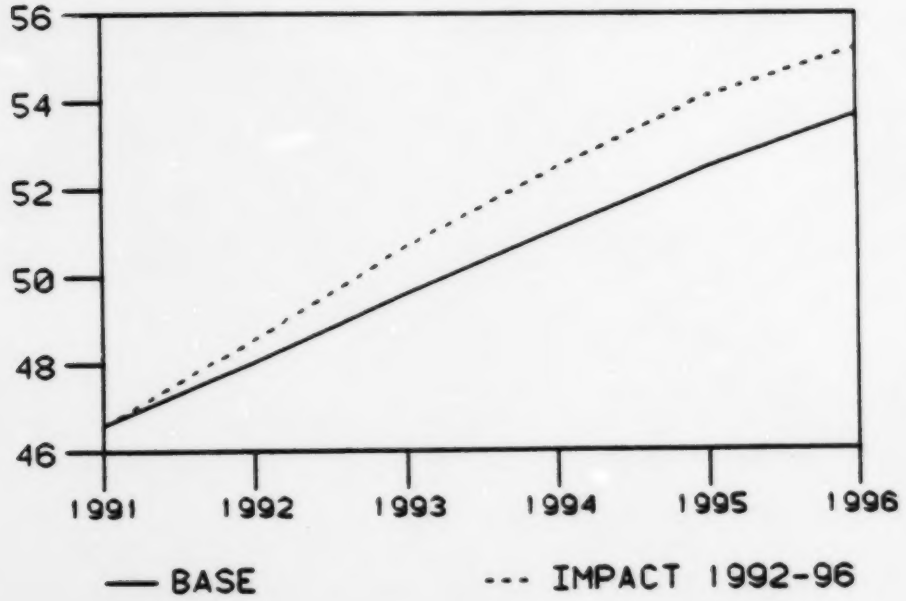
BRITISH COLUMBIA
GROSS DOMESTIC PRODUCT, 1988-93
(billions of 1981 dollars)

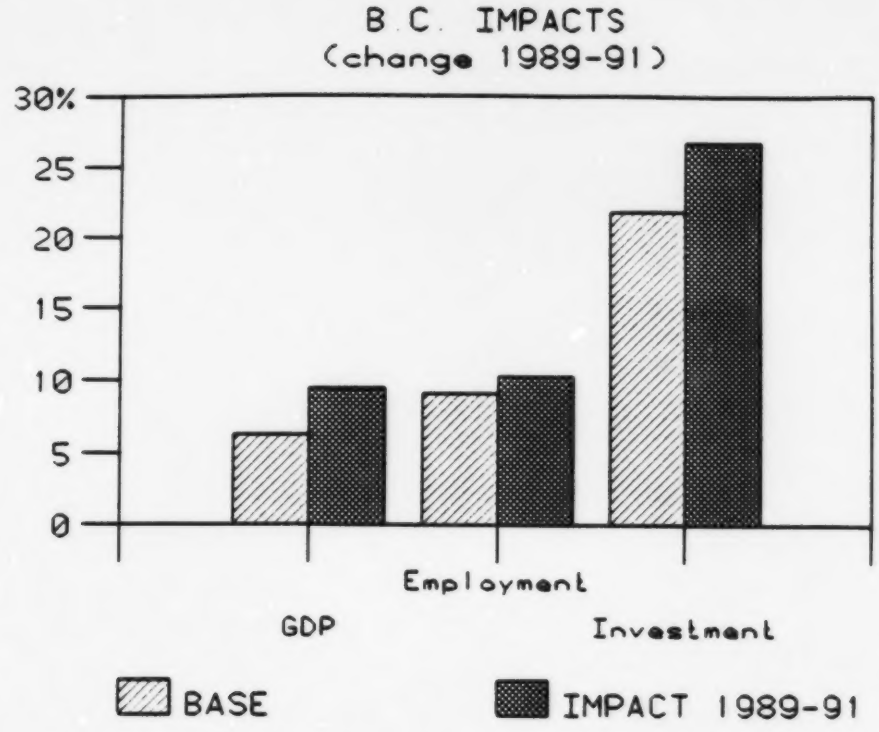


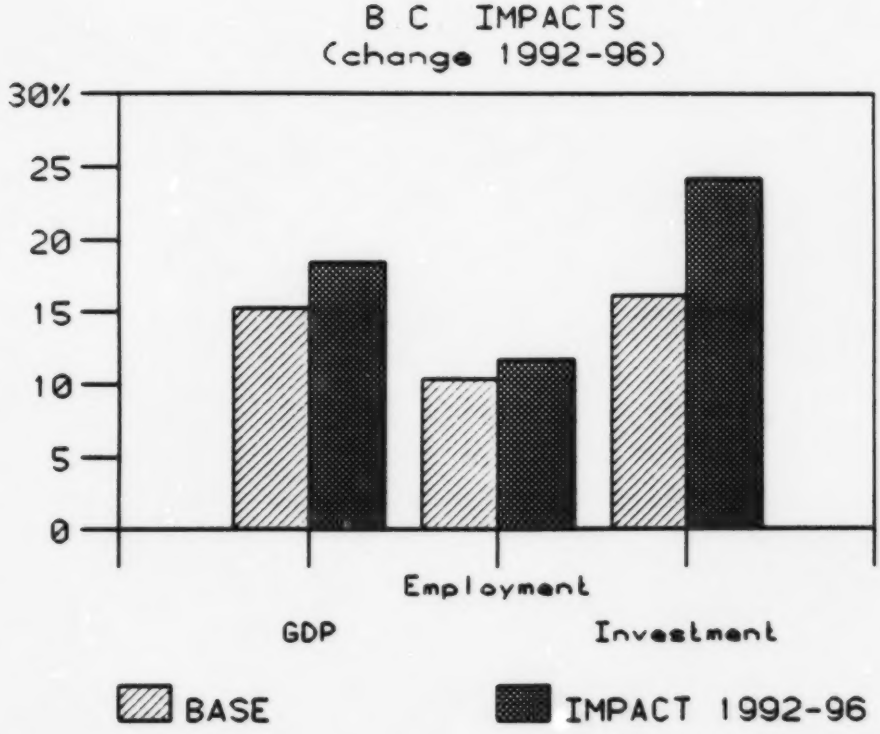
CANADA
GROSS DOMESTIC PRODUCT, 1991-96
(billions of 1981 dollars)



BRITISH COLUMBIA
GROSS DOMESTIC PRODUCT, 1991-96
(billions of 1981 dollars)




B C IMPACTS
(change 1989-91)
30%
25
20
15
10
5
0
Employment
GDP
Investment
BASE
IMPACT 1989-91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An Economic Assessment of Federal Monetary Policy

1 INTRODUCTION

The purpose of this paper is to assess the impacts of federal monetary policy on the Canadian economy and the British Columbia economy. As well, the potential gains and tradeoffs associated with an alternative monetary policy are examined.

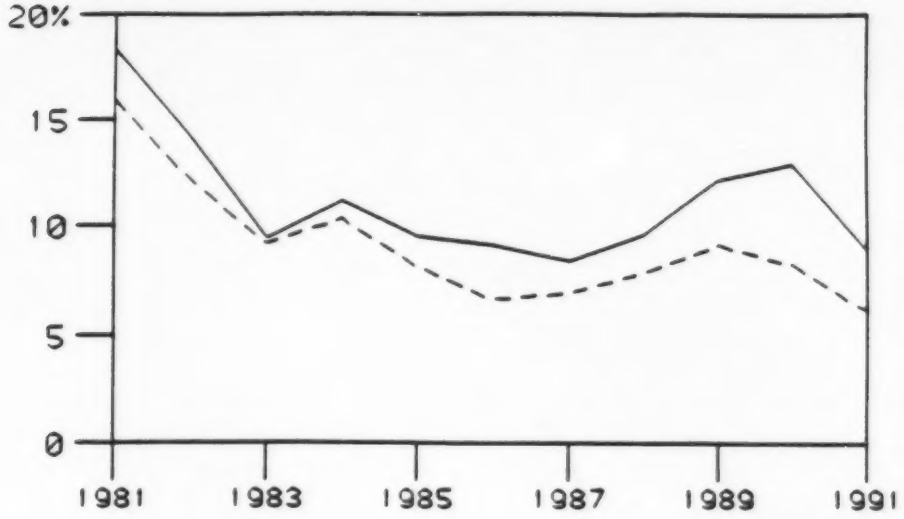
The Bank of Canada viewed the increase in demand during the 1987-88 period as a potential threat to their objective of price stability. U.S. interest rates were also rising in 1987 and 1988. As a result they moved Canadian interest rates higher, although the differentials between Canadian and U.S. interest rates remained stable (about 150 basis points).

In 1989, however, the Bank moved to increased restraint, with short-term interest rates rising by about 2.5 percentage points (250 basis points), and the differential with U.S. interest rates widening to about 300 basis points.

In 1990, Canadian short-term interest rates rose again (averaging about 13 per cent), while U.S. rates declined by 90 basis points. The differential widened to about 470 basis points. By this time economic growth had begun to slow substantially and unemployment rose.

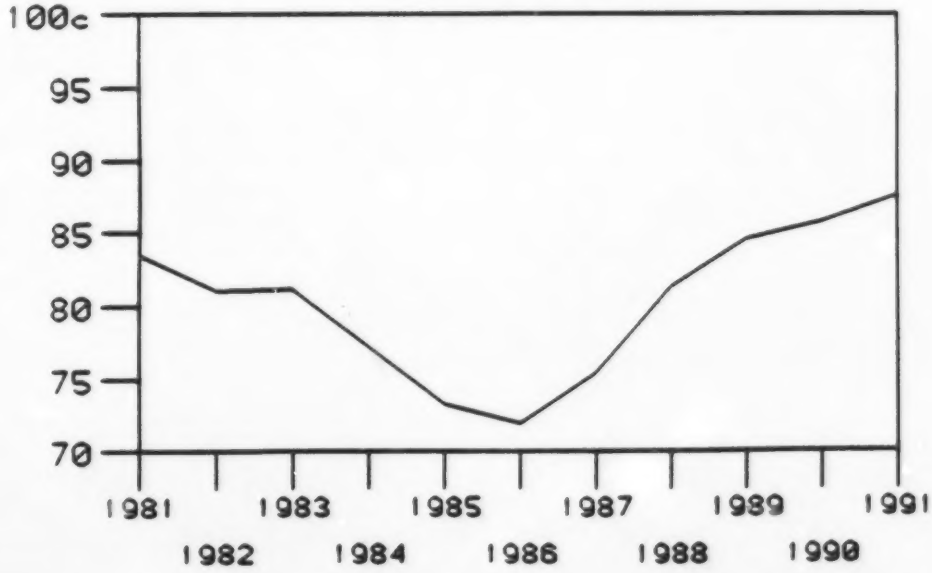
Nevertheless, in 1991 the Bank of Canada persisted with monetary restraint, maintaining a differential with U.S. interest rates of about 250 basis points. Long-term targets for price stability were promulgated on February 26, 1991 at the time of the federal budget.

SHORT-TERM INTEREST RATES
CANADA AND THE U S , 1981-91
(per cent)



Uses 90-day rates

CANADA-U S EXCHANGE RATE, 1981-91
(US cents/$CAN)



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The Federal Government and the Bank of Canada have declared that their premier objective is **price stability**, interpreted as "zero inflation". The policy package used by the Bank of Canada to achieve this objective consists of:

- o High real interest rates (nominal interest rates less the inflation rate).
- o A large interest rate differential with the United States, encouraging exchange rate appreciation.
- o A public statement of inflation targets (3 per cent by the end of 1992, 2.5 per cent by mid-1994, and 2 per cent by the end of 1995).

The Department of Finance has provided strong public support for the Bank's policy, and has also reinforced the thrust by:

- o Discretionary fiscal restraint through higher taxes and reduced expenditures, both to maintain the deficit under some control in face of higher interest rates and to help raise the unemployment rate.
- o Reduction in payments to the provinces, leading to various combinations of higher taxes, reduced expenditures, or larger deficits.
- o Imposition of wage controls on federal salaries (zero in the first year, three per cent in years two and three).

These policies have had the effect of:

- o Slowing economic growth, thereby raising the unemployment rate to a level sufficient to reduce wage demands (above NAIRU - the Non-Accelerating Inflation Rate of Unemployment),
- o Curtailing business investment, new housing, consumer spending, and other private spending sensitive to interest rates, and
- o Raising the costs to governments of carrying debt, thus forcing on them expenditure restraint or tax increases.

The Bank's underlying view is that "real" economic performance in the longer term will not be adversely affected by the pursuit of the Zero Inflation Target (ZIT), and, indeed, that growth will be enhanced by zero inflation, through a positive impact on allocative efficiency and on productivity growth. (Short-term pain for long-term gain!)

At the same time, the federal government has been pursuing a set of structural policies with the objective of reducing rigidities, enforcing competition, and privatizing some functions previously performed by government. These policies include the Free Trade Agreement, deregulation of transportation and financial institutions, revisions to the Competition Act, and tax reform. Presumably such policies are seen as complementary to inflation reduction and vice versa.

2 EVALUATION OF CURRENT MONETARY POLICY

How is it possible to be critical of such efforts? No reasonable person is against the idea of containing inflation, per se. But, given the negative economic consequences associated with a restrictive monetary policy, a strong argument can be made that a stable and modest inflation rate is preferable to a Zero Inflation Target (ZIT), on both theoretical and practical grounds.

The exclusive focus on one policy target, coupled with the notion of "sequential" policy action, with first zero inflation being achieved and then other issues being addressed, does not offer a sensible approach. The Canadian economy is complex, and it is the **simultaneous** achievement of progress on several objectives that is important. Tradeoffs, too, are inevitable, and more likely to be supported if the balancing is simultaneous and not separated in time.

Before turning to a closer look at monetary policy, we should address another issue that is sometimes raised. Is it possible that the high interest rate policy is being forced on the Bank of Canada by capital markets, implying that the notion of independent monetary policy is simply a charade? This view usually claims that government deficits are "crowding out" private borrowers and raising interest rates in the process. The more sophisticated version suggests that private borrowers are crowded out to international markets, thereby raising the exchange rate and the eventual costs of repayment on the borrowed capital. There is little empirical support for this view.

If this was the problem, then the policy response would be to emphasize deficit reduction more and restrictive monetary policy less. In a similar vein, it is possible for a central bank to pursue a rule that says it will increase interest rates whenever the fiscal authorities increase their deficit. But the "blame" for the "crowding out" should be assigned to the central bank, not to "capital markets".

Although Canada is an active participant in international capital markets its borrowing has little impact on international interest rates. At the same time, the Bank of Canada has demonstrated its capacity to deviate from the international level of interest rates for extended periods. Clearly, if Canada pursues a monetary policy that produces positive real interest rates and accepts exchange rate flexibility it should not be hampered in international capital markets.

The single-minded focus of monetary policy on zero inflation is misplaced. This conclusion flows from several different views about the efficacy of monetary policy. The four levels of "suspicion" about the current tight monetary policy are:

- **The policy is not effective quickly.** Lags in the economic system, multi-year collective bargaining, gradualism in application, and resistance by various groups give rise to larger losses than anticipated.

- **The policy is simply not effective.** The levers that are being moved by monetary policy are not "strongly connected" to those forces causing inflation. Over the longer haul, monetary policy is directed, of course, towards controlling the aggregate price level. But it can also alter relative prices, particularly between domestic and foreign prices via the

exchange rate, and between the present and future through interest rates. But domestic inflation can be driven by other forces, including U.S. developments, inertia, market power shifts, commodity price shocks, and other government policies.

- **The policy is counter-productive.** Too stringent monetary policy postpones indefinitely the return to "fuller" employment. Deficits of governments are made worse through higher financing costs, leading to program cutbacks and tax increases, which in turn are inflationary and create distortions. Business overhead costs are raised by interest charges, wage pressures emerge in response to higher financing costs and indirect tax increases, all of which increase inflationary pressures. In some circumstances this has resulted in higher inflation, not lower, after several years.

- **The policy harms economic growth and productivity.** High interest rates redistribute income between creditors and debtors, leading to more bankruptcies (corporate and personal), higher probabilities of credit crises, failure and layoffs for enterprises (financial and non-financial), rising domestic debt-to-income ratios, a rising international debt-to-exports ratio, an ongoing need for distorting taxes, and the removal of flexibility in fiscal policy to deal with any cyclical weaknesses. Productivity is damaged, both through the lack of private capital investment and public infrastructure, and from weak output growth.

An effective macroeconomic strategy calls for balance and interplay, and an exclusive focus on zero inflation is not that. Rather, the real macroeconomic policy challenge should be to **simultaneously** achieve full employment and a sensible inflation objective, not one at the expense of the other. In this manner, the likelihood of achieving the basic goal of rising living standards is greatest.

Today, when inflation rates in an open economy such as Canada are relatively low and generally in line with our major trading partners, the benefits of restrictive monetary policy and zero inflation can be overestimated, and the costs underestimated. If the exercise of anti-inflation policy results in the loss of employment and output, there is a permanent loss to society - not to be regained. In addition, the loss of new investment and failed businesses permanently lower the potential of the economy, by reducing productivity growth.

In the special circumstances following the Canada-U.S. Free Trade Agreement, it is particularly puzzling why the opportunity to encourage business investment in Canada has been forgone, with the deadly combination of high interest rates and an over-valued currency. Plant location decisions are long term in nature. If we miss these opportunities they are not quickly regained.

Would the economy be better off if the Bank of Canada's zero inflation target were achieved?

If inflation in the U.S. continues at a stable, but positive, rate of 4 per cent, and Canada has zero inflation, then this should imply continuing pressure for nominal appreciation of the Canadian dollar. The Bank, however, does not have to accommodate this pressure. Instead, it could lower Canadian interest rates gradually, allowing lower real interest rates and a real depreciation of the Canadian dollar, with positive implications for the trade balance and economic activity. But this time for "unwinding" of current policy over several years should be included in any estimates of its costs and benefits.

Is it desirable, or even possible, to have a zero rate of inflation in a "global village" that does not have the same? Canada would be out-of-step, leading to the possibility of misread signals. While the Bank emphasizes the value of a Canadian economy in which inflation does not influence decisions, it should be recognized that **differential** rates of inflation with our major trading partners (higher or lower) require that both Canadian and foreign decision-makers take account of the divergence of international trends. In the case of Canada, there is substantial foreign ownership and involvement in economic decisions. In such an environment does it make any sense to try to force a markedly different inflation rate?

Moreover, at a zero inflation rate, there will be a weakening of the domestic adjustment mechanism now in place for accommodating changes in relative prices and wages. With modest inflation, changing relative prices occur "passively" and without much noticeable friction. Those who do not adjust upward their nominal price levels have effectively lowered their prices. With zero inflation, these relative price adjustments may become more difficult because they will require actual reductions to be made. Price and wage rigidities are a reality in the Canadian economy, and it makes more sense to pursue a policy that minimizes the consequences of these rigidities, rather than trying to force institutions to change their practices.

There are two dangers in waiting for several years to see the outcome of current policies. It is likely that Canada will become even more "out-of-kilter" with other trading nations the longer we maintain current policies. In addition, there is the danger that we will destroy too many of our businesses and institutions, weaken remaining businesses, undermine the credibility of governments, and sour industrial relations to the point where reaching any consensus on a new direction will be most difficult.

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3 THE ECONOMIC IMPACT OF LOWER INTEREST RATES, 1989-93

As outlined above, the Bank of Canada has pursued a particularly restrictive monetary policy since 1989. This policy was able to tip the Canadian economy into a recession in early 1991. What would have happened if the policy setting in 1988 had been maintained, rather than moving to the more restrictive policy?

It is, of course, not possible to start over again. Yet it can be useful to ask what might have happened if monetary policy had been different. In this section, the question posed is, "What would have happened if the Bank of Canada had maintained interest rates at the 1988 differential between Canadian and U.S. interest rates and the exchange rate at the 1988 level?"

This simulation starts with a "Base Case", using a recent forecast of the national and provincial economies. This was produced by Informetrica Limited using its models, TIM - The Informetrica Model of the national economy, and RIM - the Regional-Industrial Model for the provincial economies. Then the assumptions for interest rates and the exchange rate are altered, and a new forecast is produced. By taking the difference between the two forecasts, the impact of the altered interest rates and exchange rate can be seen. The changes are introduced in 1989 and continued through 1993, allowing for an assessment of both the initial impacts and the longer-term effects.

The alternative assumptions then boil down to three:

- The short-term differential between Canadian and U.S. interest rates is maintained at the 1988 level. This results in Canadian short-term interest rates being lower by 1.25% in 1989, 3.00% in 1990, 1.00% in 1991, and with no change in 1992 and 1993.

- The exchange rate is maintained at the 1988 level of 81.25 U.S. cents per Canadian dollar. This implies a depreciation of 3.21 cents in 1989, 4.45 cents in 1990, and 6.24 cents for 1991 through 1993.

- Long-term interest rates are also lower, but with a lag. In 1989, 0.16% lower, 1990 - 1.29%, 1991 - 0.81%, 1992 - 0.66%, and 1993 - 0.85%.

3.1 Major National Impacts

The choice of not subjecting the economy to a strong dose of monetary restraint has the expected impact. Real output is higher in all years from 1989 through 1993, unemployment is lower, productivity is higher, corporate profits improve, and government deficits are lower. The price level is higher, as should be expected with a lower dollar throughout the period. The rate of inflation, measured by the change in the CPI, is higher by 0.5% to 1.1%. (The major economic impacts are summarized in Table 1.)

Table 1. Major Economic Indicators: Canada

Impact 1989-1993	1989	1990	1991	1992	1993
			% Impact		
Gross domestic product at market prices (Bn$81):					
Consumption expenditure	-0.15	0.07	0.48	0.67	0.46
Government expenditure	0.34	0.66	1.11	1.09	0.83
Business investment	0.53	2.45	5.39	4.85	2.88
Residential	0.62	1.34	3.61	2.50	1.79
Nonresidential construction	0.91	2.62	4.84	3.80	2.10
Machinery & equipment	0.2[illegible]	3.05	6.77	6.89	3.99
Inventory change (a)	0.6	1.3	1.7	1.1	-0.2
Net exports (a)	2.4	2.7	3.8	3.5	3.2
Exports (+)	1.36	2.34	4.03	3.89	2.95
Imports (-)	-0.20	0.69	1.78	1.87	1.18
Gross Domestic Product	0.77	1.59	2.89	2.66	1.71
Nonresident Invest. Income					
Receipts (+)	-0.29	-0.25	-0.09	-0.80	-2.00
Payments (-)	0.96	0.11	0.61	0.20	-2.06
Gross National Product	0.74	1.65	2.96	2.73	1.84
Final Domestic Demand	0.11	0.72	1.67	1.69	1.10
Labour market (000s):					
Source population	0.00	0.00	0.00	0.00	0.00
Total participation rate ((a)	0.03	0.03	0.04	0.05	0.09
Labour force	0.04	0.04	0.06	0.08	0.13
Employment	0.23	0.59	1.12	1.41	1.18
Unemployment	-2.32	-6.17	-9.14	-11.60	-9.18
Unemployment rate (%) (a)	-0.18	-0.50	-0.95	-1.19	-0.94
Bus. Capital Stock ($Mn81)	0.03	0.18	0.49	0.77	0.91
Wages and prices:					
Wages per employee ($C)(1)	0.80	1.45	2.29	2.89	4.08
Bus. labour inc./employee	0.94	1.70	2.69	3.25	4.36
Wages	0.95	1.87	2.98	3.82	4.72
Supplementary	0.86	0.10	0.04	-1.73	1.42
Output per employee ($81)	0.57	1.05	1.80	1.25	0.58
Bus. output per employee	0.67	1.21	2.07	1.39	0.61
Total unit labour cost	0.23	0.39	0.49	1.61	3.48
Implicit deflator of imports	3.72	4.99	6.82	6.77	6.79
Impl. defl. of imported oil	3.95	5.48	7.68	7.68	7.68
Implicit deflator of GDP	0.97	1.31	1.62	2.40	3.72
Consumer price index	1.10	1.63	2.15	2.69	3.60
Year-to-Year Change (%) (a)	1.13	0.56	0.54	0.55	0.92

(a) Level Impact

Table 1. Major Economic Indicators: Canada

Impact 1989-1993		1989	1990	1991	1992	1993
				% Impact		
Gross domestic product at factor cost (Bn$81):						
Gross domestic product		0.81	1.67	2.97	2.72	1.80
Industrial production		1.66	3.51	5.85	5.22	3.34
Mining		1.19	2.18	3.76	3.25	2.04
Manufacturing		1.89	4.12	6.95	6.17	3.90
Utilities		1.15	2.31	3.56	3.31	2.36
Incomes (Bn$C):						
Disp. income/capita ($81)		-0.22	-0.31	0.20	0.55	0.02
Corp. profits before taxes		11.26	14.78	24.84	17.98	10.87
GDP at factor cost		1.78	2.96	4.72	5.28	5.62
Savings rate (%)	(a)	0.1	0.1	0.0	-0.1	-0.4
All gov't balance	(a)	2.2	3.7	6.7	6.2	7.2
Federal	(a)	2.1	4.5	5.6	4.5	6.0
Net Financial Liabilities as per cent of GDP	(a)	-1.0	-2.2	-3.8	-4.6	-5.3
Prov. & local, hospitals	(a)	0.0	-0.5	1.4	2.0	1.5
Provincial	(a)	0.5	0.3	2.2	2.7	2.3
Local	(a)	-0.3	-0.6	-0.5	-0.5	-0.6
Hospital	(a)	-0.2	-0.2	-0.3	-0.2	-0.2
Canada & Quebec pensions	(a)	0.1	-0.3	-0.3	-0.3	-0.3
Current account balance	(a)	0.6	0.7	0.6	0.6	1.7
Merchandise trade balance	(a)	1.3	1.3	1.6	1.6	2.4
Population and housing (000s)						
Net immigration	(a)	0.00	0.00	0.00	0.00	0.00
Total fert. (child./woman)	(a)	0.00	0.00	0.00	0.00	0.00
Population		0.00	0.00	0.00	0.00	0.00
Households		-0.01	-0.01	-0.02	-0.02	-0.01
Housing starts	(a)	3.08	5.75	15.54	6.36	2.90
Financial:						
Exchange rate (centsUS/$Ca	(a)	-3.21	-4.45	-6.24	-6.24	-6.24
Real exchange rate	(a)	-2.54	-3.50	-5.10	-4.44	-3.34
90-day commercial paper	(a)	-1.25	-3.00	-1.00	0.00	0.00
Real 90-day rate (2)	(a)	-2.27	-3.35	-1.31	-0.79	-1.32
Corp. long-term bond yield	(a)	-0.16	-1.29	-0.81	-0.66	-0.85
Real bond yield (2)	(a)	-0.37	-1.57	-1.15	-1.15	-1.60

(a) Level Impact
Sources: Statistics Canada, L. H. Meyer & Associates and Informetrica Limited
Notes: (1) Includes supplementary labour income
(2) Uses GDP deflator at market prices

3.1.1 The Real Economy -

Real GDP is higher in all years, ranging from 0.8% in 1989 to 2.9% higher in 1991. Business investment responds quite strongly to the lower interest rates and increased activity. By the end of the five-year period, the business capital stock is higher by 0.9%.

Exports also respond to the lower dollar, increasing by 1.4% in the first year, and almost 3% in 1991. Imports also increase, reflecting the higher activity and lower dollar. Machinery and equipment investment in particular raises imports of capital goods.

The unemployment rate by 1991 is one percentage point lower. While this would be welcomed, it also shows that this policy alone would not have protected Canada from the adverse effects of the world oil price shock that accompanied the Gulf War, and the resulting weakness in the U.S. and rest-of-world economies.

Real output per person is higher throughout the period. This improvement is "cyclical". As well it is influenced by the mix of output increases, which show larger positive impacts on the mining, manufacturing, and utilities sectors which have high productivity levels.

3.1.2 Inflation -

The exchange rate effects in this case are not constant throughout the period. The dollar depreciates from the Base Case by 4% in 1989, an additional 1.5% in 1990, and a further 2.2% in 1991. The total depreciation of 7.7% is then maintained for 1992 and 1993. The CPI increases by 1.1% in 1989, by 0.5% per year from 1990 through 1992, and by 0.9% in 1993. This inflation pattern is linked to the exchange rate depreciation.

Wages per employee keep in line with the higher CPI; unit labour costs rise less rapidly, given the productivity improvement.

3.1.3 Government Balances -

The combination of lower interest rates and more economic activity help federal and provincial government balances over the entire period. The federal deficit is reduced by $2 billion in 1989, by $6.7 billion in 1991, and by over $7 billion in 1993. Provincial governments are also better off, with an improvement in 1989 of $500 million, rising to over $2 billion from 1991 on.

This change would have provided additional room for fiscal stimulus, if the governments had wanted to mitigate the effects of slower growth abroad.

3.1.4 Sectoral Incomes -

Corporate profits are enhanced over the entire period, rising by $6 billion to $9 billion per year relative to the Base Case. At the same time, real disposable income per capita is little changed, although consumer expenditures increase as a result of lower interest payments on consumer debt.

3.2 The Provincial Impacts

The provincial impacts are determined by the detailed industrial impacts from the national model. Changes in activity are allocated to each industry in each province, based on the distribution of outputs. These output shares change over time, reflecting new investment decisions as well as the overall provincial activity. The implicit assumption is that there is capacity in each province to handle the additional output.

Interprovincial migration also occurs, with movements affected by the relative economic performance of each province, and historical behavior of household movements. In an impact case, these movements are usually small, resulting in quite modest effects on the impacts on unemployment rates and provincial GDP. In all measures, the national impacts are maintained; thus an increase in one region is offset by a decrease elsewhere.

All provinces are better off, in terms of higher output, more employment, and lower unemployment rates. The patterns reflect the strong positive effects on manufacturing, with the largest gains in Ontario and Quebec. This is traceable to the strong trade links and the large share of capital goods manufactured in Ontario and Quebec.

Saskatchewan and Prince Edward Island, while still positive, show the smallest impacts, reflecting the relatively large share of agriculture in these provinces.

3.2.1 The British Columbia Economy -

British Columbia GDP Impacts

Impact 1989-1993		1989	1990	1991	1992	1993
				% Impact		
GROSS DOMESTIC PRODUCT (MN)						
Constant 1981 dollars		0.83	1.65	2.91	2.60	1.70
Current dollars		1.55	2.49	4.18	4.75	5.20
Current dollars	(a)	984.2	1634.7	2844.6	3422.3	3980.1

(a) Level Impact

Total output, measured by real GDP at factor cost, is higher by 0.8% in 1989, and 2.9% in 1991. As a consequence, employment is improved by over 5,000 in 1989, 15,000 in 1991, and by almost 19,000 in 1992. The unemployment rate is lowered by more than 1 percentage point from 1991 on.

British Columbia Labour Market Impacts

Impact 1989-1993	1989	1990	1991	1992	1993
			Impact		
Employment ('000s)	5.3	7.1	15.0	18.8	16.5
Unemployment Rate (%)	-0.3	-0.6	-1.1	-1.3	-1.1

British Columbia Investment Impacts

Impact 1989-1993	1989	1990	1991	1992	1993
			% Impact		
INVESTMENT ($81 MN)					
Nonresidential Structures	0.92	2.19	3.81	2.46	0.64
Machinery and Equipment	0.27	2.21	4.04	3.59	3.30
Residential Structures	0.59	1.23	3.22	3.25	1.81
Dwelling Starts ('000) (a)	0.5	1.1	2.5	1.1	0.4

(a) Level Impact

Investment increases in all years, with machinery and equipment spending over 4% higher in 1991, and nonresidential structures up by 3.8%. Housing starts are higher, peaking at 2,500 additional starts in 1991.

The impact on the provincial CPI is quite similar to the national CPI, differences are attributable to different weighting patterns.

Impact on British Columbia Fiscal Balance

Impact 1989-1993	1989	1990	1991	1992	1993
			Impact		
Fiscal Balance	83.7	262.9	492.6	595.0	561.6
Cumulative Balance (change in debt)	83.7	346.6	839.2	1434.2	1995.8

The provincial fiscal balance is also improved. Higher revenues result from improvements in tax revenues, given the increased nominal incomes of consumers and business. Expenditures also rise, but less rapidly. Absolute declines in welfare payments and decreased interest payments on the public debt partially offset the increases due to the larger economy and higher price level. The net effect is an improved balance of about $84 million in 1989, rising to over $500 million from 1991 on.

4 ECONOMIC IMPACT OF AN ALTERNATIVE MONETARY POLICY, 1992-96

In the previous section, the economic effects of a different monetary policy over the period from 1989 to 1993 have been discussed. However, it is impossible to back up and start again. In this section, the focus is on the future economic impacts of a monetary policy change now.

The major element of this change is lower interest rates, accompanied by a depreciation of the exchange rate. There is no generally accepted "rule-of-thumb" linking interest rate changes and exchange rate movements, although most observers would expect some depreciation if Canada unilaterally lowered interest rates, at least in the short run. The lack of consensus reflects the many factors that might impinge on the exchange rate in addition to interest rate effects. These include changes in the price level in Canada relative to the price level in other countries, changes in the current account balance, changes in relative growth prospects, and alterations in lending and borrowing patterns in international capital markets.

To illustrate the possible impacts of lower interest rates, it is assumed that:

- Canadian short-term interest rates are reduced by two percentage points (200 basis points),
- long-term interest rates are lowered by 165 basis points with a one-year lag, and
- the Canadian dollar depreciates by four per cent, from 87.5 U.S. cents per Canadian dollar, to 84.125 cents.

4.1 Major National Impacts

The combination of lower interest rates and a lower exchange rate result in more output, lower unemployment, improved balances for the federal government and provincial governments, and improved productivity.

At the same time, the consumer price index is higher, wages increase, and the fiscal position of local governments, hospitals, and pension plans are slightly worsened. The net effect on the current account balance is modest, with the improvements from a lower exchange rate being offset by increased imports resulting from more investment and consumption. (The major economic impacts are summarized in Table 2.)

Table 2. Major Economic Indicators: Canada

Impact 1992-1996	1992	1993	1994	1995	1996
			% Impact		
Gross domestic product at market prices (Bn$81):					
Consumption expenditure	-0.05	0.59	0.90	1.19	1.23
Government expenditure	0.51	0.97	1.34	1.60	1.52
Business investment	1.66	4.93	7.61	9.52	8.64
Residential	1.81	2.60	3.30	3.90	4.41
Nonresidential construction	1.94	5.70	8.78	10.56	9.09
Machinery & equipment	1.42	5.89	9.41	11.87	10.48
Inventory change (a)	0.9	1.7	1.7	1.5	0.7
Net exports (a)	2.7	1.5	0.6	-0.6	-0.7
Exports (+)	1.91	2.75	3.33	3.60	3.21
Imports (-)	0.37	1.90	3.03	3.91	3.53
Gross Domestic Product	1.21	2.31	3.02	3.48	3.17
Nonresident Invest. Income					
Receipts (+)	0.31	0.87	1.07	0.89	0.35
Payments (-)	-0.65	-1.16	-1.49	-1.81	-2.27
Gross National Product	1.28	2.45	3.19	3.67	3.37
Final Domestic Demand	0.45	1.67	2.59	3.35	3.18
Labour market (000s):					
Source population	0.00	0.00	0.00	0.00	0.00
Total participation rate ((a)	0.01	0.00	0.04	0.07	0.12
Labour force	0.02	0.01	0.05	0.11	0.17
Employment	0.42	0.92	1.30	1.61	1.63
Unemployment	-3.54	-8.14	-11.16	-13.87	-13.52
Unemployment rate (%) (a)	-0.36	-0.83	-1.12	-1.36	-1.31
Bus. Capital Stock ($Mn81)	0.09	0.40	0.88	1.50	2.01
Wages and prices:					
Wages per employee ($C)(1)	0.75	0.72	0.97	1.50	1.96
Bus. labour inc./employee	0.88	0.99	1.37	1.98	2.44
Wages	0.90	1.32	1.76	2.34	2.87
Supplementary	0.71	-1.81	-1.97	-1.10	-1.16
Output per employee ($81)	0.84	1.45	1.77	1.89	1.59
Bus. output per employee	0.96	1.63	1.97	2.08	1.72
Total unit labour cost	-0.10	-0.72	-0.78	-0.38	0.36
Implicit deflator of imports	3.48	3.17	2.91	2.75	2.75
Impl. defl. of imported oil	4.00	4.00	4.00	4.00	4.00
Implicit deflator of GDP	0.51	-0.02	-0.19	0.01	0.58
Consumer price index	0.83	0.51	0.40	0.64	1.04
Year-to-Year Change (%) (a)	0.85	-0.33	-0.11	0.24	0.41

(a) Level Impact

Table 2. Major Economic Indicators: Canada

Impact 1992-1996		1992	1993	1994	1995	1996
				% Impact		
Gross domestic product at factor cost (Bn$81):						
Gross domestic product		1.28	2.41	3.13	3.58	3.29
Industrial production		2.72	4.52	5.40	5.91	5.24
Mining		1.96	3.22	4.14	4.70	4.19
Manufacturing		3.11	5.15	6.03	6.54	5.77
Utilities		1.85	3.12	3.76	4.09	3.63
Incomes (Bn$C):						
Disp. income/capita ($81)		-0.43	-0.03	0.05	0.19	0.16
Corp. profits before taxes		14.84	11.52	11.59	12.72	9.97
GDP at factor cost		1.79	2.38	2.95	3.62	3.88
Savings rate (%)	(a)	0.0	-0.2	-0.4	-0.5	-0.6
All gov't balance	(a)	3.2	5.8	8.8	10.7	10.9
Federal	(a)	4.2	5.9	7.5	8.8	8.6
Net Financial Liabilities as per cent of GDP	(a)	-1.3	-2.4	-3.4	-4.5	-5.4
Prov. & local, hospitals	(a)	-0.9	0.4	1.9	2.3	2.5
Provincial	(a)	0.0	0.9	2.3	2.9	3.2
Local	(a)	-0.5	-0.4	-0.3	-0.5	-0.6
Hospital	(a)	-0.4	-0.1	0.0	-0.1	-0.1
Canada & Quebec pensions	(a)	-0.1	-0.5	-0.6	-0.4	-0.3
Current account balance	(a)	1.1	0.3	-0.5	-1.5	-1.0
Merchandise trade balance	(a)	1.2	0.0	-0.8	-1.7	-1.2
Population and housing (000s)						
Net immigration	(a)	0.00	0.00	0.00	0.00	0.00
Total fert. (child./woman)	(a)	0.00	0.00	0.00	-0.01	-0.01
Population		0.00	0.00	0.00	-0.01	-0.01
Households		0.00	0.00	0.00	0.00	0.02
Housing starts	(a)	7.70	10.86	12.11	13.38	14.37
Financial:						
Exchange rate (centsUS/$Ca	(a)	-3.37	-3.37	-3.37	-3.37	-3.37
Real exchange rate	(a)	-3.04	-3.50	-3.61	-3.40	-2.89
90-day commercial paper	(a)	-2.00	-2.00	-2.00	-2.00	-2.00
Real 90-day rate (2)	(a)	-2.52	-1.46	-1.83	-2.20	-2.59
Corp. long-term bond yield	(a)	-0.82	-1.65	-1.65	-1.65	-1.65
Real bond yield (2)	(a)	-0.93	-1.64	-1.61	-1.65	-1.77

(a) Level Impact
Sources: Statistics Canada, L. H. Meyer & Associates and Informetrica Limited
Notes: (1) Includes supplementary labour income
(2) Uses GDP deflator at market prices

4.1.1 The Real Economy -

As a consequence of lower interest rates and a lower exchange rate, real Gross Domestic Product is higher over the entire period, ranging from over 1% in the first year to more than 3% from the third through fifth years. The largest impacts are on business investment, with both nonresidential construction and machinery and equipment investment responding to the lower interest rates and increased activity. Housing starts are up 8,000 to 14,000 per year over the five years. The business capital stock is 2% higher after five years, suggesting a continuing improvement in the productive capacity of the economy.

Exports expand in real terms, to a level 3.6% higher than the Base Case by the fourth year, with a slightly smaller impact in the last year, as higher domestic prices offset some of the advantage from the exchange rate.

Consumer expenditure is modestly higher, even though real incomes are little changed. A lower savings rate and less interest on consumer debt provide the spending power for the roughly 1% increase in consumer expenditure.

Government expenditure on goods and services increases in line with the economy. Inventory investment is also positive, contributing to the positive growth.

As a consequence of higher output, employment increases by 0.4% in the first year, rising to 1.6% by years four and five. This means over 200,000 additional workers at the end of the period. In the first year, the unemployment rate declines by 0.4%. By the fourth year, it is more than 1.3% lower. This reduces the Base Case unemployment rate from 9.7% to 8.4%.

Output per person (labour productivity) also improves over the entire period, rising from 0.8% higher than the Base Case in 1992 to 2% by the third year. Part of the increase is attributable to the larger capital stock per worker, but most would reflect a cyclical improvement and a mix effect from expansion occurring in higher productivity level industries.

With the expansion of demand occurring in investment and exports, it should not be too surprising that mining and manufacturing show above-average increases in output over the entire period. At the same time, domestically-based sectors, such as finance, health, and education, are affected more modestly. Agriculture output is not impacted substantially in these simulations, although farm incomes would be improved with the higher prices for exports.

4.1.2 Inflation -

The immediate effect of a depreciation is to raise the price of imported goods by the full amount of the depreciation (4%). In turn, these goods affect the CPI (and other prices) based on the import content of these prices. In addition, some domestic prices react positively to higher foreign prices expressed in Canadian dollars. If only the exchange rate effects are considered, about 25% of the depreciation enters the CPI in the first year, with 50% imbedded in the fifth year.

The lower interest rates alone help to reduce the CPI. This is attributable to the positive effect of lower interest rates on productivity, the reduction of some regulated prices, and lower mortgage interest costs.

The combined effect is a CPI that is higher by 0.8% in the first year, only 0.5% in the third year, and about 1% in the fifth year. The change in the CPI, or the inflation rate, is only altered significantly in the first year, with a 0.85% higher increase. In the second and third years, inflation is actually lower than in the Base Case, and only fractionally higher in the fourth and fifth year. The effect of the depreciation is similar to the one-time impact of a sales tax increase, impacting the rate of inflation in the year of introduction, but not otherwise.

Domestic inflation is not a problem for most of the period under study. The GDP deflator increases 0.5% in the first year, reflecting the impact of higher prices for most resources due to the depreciation. In subsequent years, the higher productivity levels first lower unit labour costs sufficiently to actually lower the domestic price level. By the end of the five-year period, the implicit deflator of GDP is only 0.6% higher. Unit labour costs are 0.4% higher, with a 2% increase in the level of wages being offset by an increase of 1.6% in productivity.

4.1.3 Government Balances -

This combination of policies certainly helps the fiscal position of federal and provincial governments. After five years, the level of federal debt is lower by $35 billion or 5.4% of GDP. At the same time, provincial debt is lowered by $9.3 billion.

The federal deficit is reduced by $4 billion in the first year, rising to almost $9 billion after three years. The provincial government balances are not affected significantly in the first year, but gradually improve to about $3 billion per year.

Lower interest rates reduce the earnings of the Canada and Quebec Pension Plans, and the slightly higher CPI increases benefit payments. Higher contributions do not fully offset these effects, leading to a small reduction in the balance of $500 million per year.

4.1.4 Sectoral Incomes -

The most dramatic impact of the depreciation and lower interest rates is on corporate profits, which increase by 15% in the first year, and are still 10% higher by 1996. Most of the improvement in the first few years is attributable to the depreciation; in later years the effects of lower interest rates contribute significantly. The percentage impact is so large partially because of the depressed levels of corporate profits in recent years. The nominal impact is $6.6 billion in the first year, about 1% of GDP in current dollars.

Real disposable income is little affected by these policies. At first this may seem surprising, but it should be remembered that the personal sector is a net asset holder, with substantial interest-bearing assets in pension plans, life insurance, and RRSPs. Lower interest rates reduce interest earnings and disposable income. The price effects of a depreciation lower real income. Fortunately, the positive effects on employment and real wages improve real disposable income. The net effect is modest. However, spendable incomes of consumers is improved. The lower interest earnings show up principally through lower savings. Lower interest rates reduce interest payments on consumer debt. Both of these effects increase the income available for consumption. In addition, lower mortgage payments provide additional discretionary income for other consumer expenditures.

4.2 The Provincial Impacts

The national impact on real GDP at factor cost is 1.3% in the first year (1992), increasing to 3.3% in the fifth year (1996). Employment increases in the first year by 0.4% and 1.6% by the fifth year. The national unemployment rate declines by 0.4% in 1992 and is 1.3% lower by 1996.

The largest provincial impact is felt in Ontario, reflecting its sensitivity to increased business investment and to trade-induced impacts on manufacturing. The first-year impact is 1.7%; the fifth year is 3.9%. Employment increases by 0.8% in the first year to 2.2% at the end of the period, while the unemployment rate is lowered by 0.4% initially and ends up 1.4% lower.

Quebec also shows an above-average impact, again traceable to its relative large manufacturing sector. Quebec GDP increases by 1.3% in 1992 and 3.6% in 1996. Employment increases are 0.4% and 2.0%, with the unemployment rate dropping by 0.4% and 1.3%.

All provinces show a positive impact on provincial GDP, with Prince Edward Island and Saskatchevan helped least, because of the relatively small impact on agriculture and its dominant role in the output of these economies.

The unemployment rate also declines in all regions. By the fifth year it is 0.4% lower in PEI, and 1.7% lower in Newfoundland. Other provinces are in between these two bounds. The relatively large impact on Newfoundland is influenced by net interprovincial out-migration, since the employment increase in Newfoundland is rather modest. This should not be interpreted as necessarily implying that there is a population decline or even net out-migration. Rather, as an impact, there is less interprovincial movement into Newfoundland and more elsewhere.

4.2.1 The British Columbia Economy -

British Columbia GDP Impacts

Impact 1992-1996		1992	1993	1994	1995	1996
				% Impact		
GROSS DOMESTIC PRODUCT (MN)						
Constant 1981 dollars		1.08	2.17	2.77	3.08	2.73
Current dollars		1.56	1.97	2.40	2.95	3.22
Current dollars	(a)	1125.1	1504.4	1938.6	2496.3	2864.1

(a) Level Impact

The effect on British Columbia's real GDP is positive throughout, with an initial impact of 1.1% in 1992, growing to 2.7% by 1996. Employment increases by 0.2% in the first year, and by 1.1% in the fifth year. This would mean 3,200 additional jobs in 1992, 14,000 by 1994, and almost 18,000 in 1995 and 1996. The unemployment rate is initially lowered by 0.4% and eventually by 1.5%.

British Columbia Labour Market Impacts

Impact 1992-1996	1992	1993	1994	1995	1996
			Impact		
Employment ('000s)	3.2	9.7	14.1	17.6	17.8
Unemployment Rate (%)	-0.4	-0.9	-1.2	-1.5	-1.5

The CPI in B.C. is affected in a similar manner to the national pattern. The total CPI impact ranges from 0.5% to 1.1%, with the only significant inflation change in the first year, up 1%.

British Columbia Investment Impacts

Impact 1992-1996		1992	1993	1994	1995	1996
				% Impact		
INVESTMENT ($81 MN)						
Nonresidential Structures		1.45	4.01	6.02	7.09	5.55
Machinery and Equipment		1.22	4.16	7.04	9.24	9.31
Residential Structures		-0.43	1.96	3.03	3.57	3.92
Dwelling Starts ('000)	(a)	0.0	1.7	1.9	2.1	2.3

(a) Level Impact

Capital investment is improved throughout the period. Machinery and equipment rises by over 9% in 1995 and 1996, with more modest increases in the earlier years. The level of nonresidential structures is higher by 1.5% in the first year to about 6% in the last three years. Housing starts increase by an average of about 2,000 per year.

Although corporate profits by industry are not forecasted by province, there is a significant improvement to the industry surplus in all years. (The industry surplus is the sum of corporate profits, capital consumption allowances, and net interest paid.) Metal mining, lumber, logging, smelting, and pulp and paper all experience substantial gains in profitability, reflecting the lower exchange rate.

Impact on British Columbia Fiscal Balance

Impact 1992-1996	1992	1993	1994	1995	1996
			Impact		
Fiscal Balance	185.2	504.4	751.1	980.4	1099.4
Cumulative Balance (change in debt)	185.2	689.6	1440.7	2421.1	3520.4

The improvement in economic performance is also reflected in the provincial government balance. Higher revenues result from the increased economic activity and higher price level. Expenditures also increase, but improved employment prospects dampen social expenditures, and the lower interest rates and lower deficit reduce interest payments. The provincial balance is improved by about $185 million in 1992, and increasing by about $250 million per year. By 1996, the balance would be enhanced by almost $1,100 million.

5 AN ALTERNATIVE PACKAGE - A NEW DIRECTION

A different monetary policy can improve the performance of the Canadian economy and that of the provinces. It can be a critical element in an alternative policy package. The elements of such a package are sketched out below.

The primary goal for economic policy should be a continued improvement in living standards for all Canadians. This can be visualized as a "larger economic pie", with attention being paid to the distribution of the pieces of the pie.

The package to achieve this goal can be described in three parts -

- **Setting of Objectives**
- **Changes in Macroeconomic Policies**
- **Fostering of Economic and Social Stability**

The first part - setting of objectives - is an important step. All parties need to know what the objectives are, both to assist in their achievement and to judge performance.

- Make a commitment to **full employment** and orient policies towards achieving this objective.
- Adopt a **productivity growth objective**, with links to real income improvements and improved international trade performance.
- Recognize that it is desirable in achieving these objectives, to recognize **environmental constraints**, to promote **regional balance**, and to encourage due regard to the **health and safety** of workers and Canadians generally.

In essence, these objectives focus on "growing the pie", through using idle resources (full employment), and by better improving the quality and utilization of these resources (productivity growth). At the same time, sensible constraints on actions are incorporated.

It may also be desirable to include a **relative** objective - essentially to aim at doing better than the United States in terms of growth, productivity, lower unemployment, and inflation, in the context of a saner use of the environment.

The second part - changes in macroeconomic policies - is essential to achieving these objectives. The "big levers" of fiscal and monetary policy along with exchange rate policy are addressed here. Other policy changes may be desirable, some of which will be discussed later.

- **Monetary Policy** - Adopt a "real interest rate" policy, maintaining real interest rates in the range of 2 to 4 per cent. At present, this would mean a drop of about two percentage points (200 basis points) from current levels for short-term interest rates (ninety-day treasury bills).

- **Fiscal Policy** - The lover interest rates will stabilize government debt-to-income ratios and reduce the interest payments on public debt dramatically. Until full employment is achieved, some of the expenditure reductions on interest should be recycled through increased expenditure on infrastructure, education, and other productivity-enhancing investments. Some deficit reduction can also occur, both to reassure the financial community of government "prudence" and to ensure that the economic expansion is financed primarily with domestic savings. When the economy is at full employment, then fiscal policy can be used to ensure that the economy stabilizes at that point.

- **Exchange Rate Policy** - The exchange rate is an important relative price in the Canadian economy. We must accept the "flexible" exchange rate that emerges from the fiscal and monetary policies ve pursue and the relative economic performance of the Canadian economy. With this policy package a depreciation is possible, but not necessarily inevitable. Improved prospects for growth, productivity, and the trade balance can offset the influence of short-term interest rate movements. An initial depreciation, if it occurs, would be a welcome stimulus to exports and import-competing industries. The key is to ensure that the adjustment in prices is more like a one-time change in level. Thereafter, with stronger growth, the Canadian dollar is likely to appreciate. The difference from the current situation is that ve would "earn" the appreciation through better economic performance.

It would be both tempting and conventional to close off the package at this point. But more is desirable, and perhaps necessary, to ensure that this policy package can stand the test of time and can achieve the objectives.

Hence the **fostering of economic and social stability** is the third part of the package. In the modern vorld, vith excellent communications, an educated population, and vell-organized groups representing various interests, any "package" must be one that people can both understand and support. Governments have a special responsibility in this area, both in the organization of the efforts and in their leadership in adopting policies. It is to these dimensions that ve nov turn.

- **Consultation Process** - With the adoption of objectives for full employment and productivity growth, it would be sensible to undertake a consultation process between "business", "labour", governments and other groups with a focus on developing a clear understanding of the need for, and sources of, "growth in the economic pie" through a more complete utilization of existing resources and productivity improvements. Discussions of the sharing of the increments to the pie may also be useful.

- **Setting of Guidelines** - After the consultation process, guidelines for vage, price, and tax changes would be set by accountable governments. The initial guidelines should have a three- to five-year horizon. They would be revieved annually, extended for a year, and videly promulgated.

- **Leadership** - Federal, provincial, and local governments would conform to the guidelines, both in the departments and in all crovn corporations.

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- **Other Government Policies** - Changes in government policies to improve productivity, enhance employment opportunities, and to ensure proper "safety nets" would receive priority. The tax and transfer system would be indexed. The issuance of "real interest rate" bonds by governments would be useful as an adjunct to monetary policy, and as an investment vehicle for pensions.

6 CONCLUSIONS

The recent period of high interest rates and restrictive fiscal policy has been damaging to the Canadian economy. Real output losses continue, unemployment is higher, and the productive capital stock has been lovered.

The British Columbia economy, as well as that of other regions, has also been damaged. The fiscal room of the provincial government has been reduced, restricting its capacity for stimulative action.

If high real interest rates are maintained in the coming years, there is every indication that there will be little relief for the unemployed. Nov is the time for a major change in economic policy.

A new policy package would represent a bold change in direction from current objectives and policies. But this package is not unique or even unusual. It is today's current tight monetary policy, with extraordinarily high real interest rates, that is unusual. Parts of this package correspond to the settings of earlier years, when Canada was indeed closer to full employment, and long before the current "experiment" with high real interest rates began. The emphasis on consultation and guidelines in the package responds to the need for developing a strong social consensus in Canada.